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Testimony

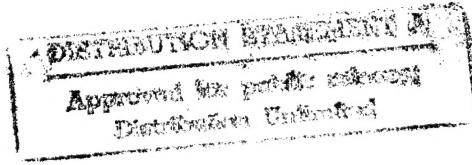
Before the Subcommittee on Legislation and National Security,
Committee on Government Operations,
House of Representatives

For Release on Delivery
Expected at
10:00 a.m., EDT
Thursday
July 23, 1992

BUDGET POLICY

Budgetary Treatment of Investment Programs

Statement of Paul L. Posner, Director of Budget Issues,
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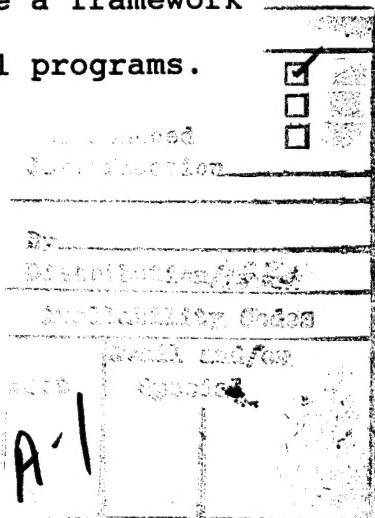
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Mr. Chairman and Members of the Subcommittee

I am pleased to be here today to discuss the importance of federal investment-oriented programs and how they can best be considered when making budgetary decisions. The nation's long-term economic future depends in large part upon budget and investment decisions made today. Current trends are not encouraging, however, as federal budget deficits have absorbed increasing proportions of national saving that might have financed productive economic investment. These deficits, in turn, have placed growing fiscal pressure on discretionary federal spending programs, including those with longer term investment-type benefits for economic growth.

The deficit has served to reinforce the preoccupation of the current budget process with short-term results and immediate cash consequences of programs for the budget, again to the detriment of those investment programs carrying longer term economic benefits. Changes are needed in our budget process to foster consideration of the longer term impacts of both our overall fiscal policy decisions as well as the choices we make among programs. Today I want to talk about how the process might be changed to provide a framework for considering the investment implications of federal programs.



ROLE OF FEDERAL INVESTMENT-ORIENTED PROGRAMS

In our June 5, 1992, report, BUDGET POLICY: Prompt Action Necessary to Avert Long-Term Damage to the Economy, (GAO/OCG-92-2), we indicated that moving from a deficit to a budget surplus was essential to improve national savings, private investment and long term economic growth. Failure to take action would, over the next 30 years, produce mounting deficits approaching 20 percent of GNP, accompanied by steady erosion of growth and the eventual contraction of the economy. Although painful in the near term, deficit reduction is essential and would yield significant long term payoffs in the form of higher GNP and lower interest costs.

That report also recognized that deficit reduction alone is not enough to promote a healthy long term economy. In addition to increasing national savings by reducing federal deficits, the federal government also can contribute by promoting an environment conducive to investment in ways that the market alone cannot provide. Federal programs can help promote an efficient public infrastructure, an educated work force, an expanding base of knowledge and a continuing infusion of innovations.

The composition of federal spending between consumption and investment-oriented activities can affect long-term economic growth in significant ways. Physical capital represents investments in infrastructure, such as highways, bridges, airports, and water

systems. Although the potential economic impact from these programs varies widely, some types of projects, such as airports and highways, almost certainly result in positive long-term economic returns.

Human capital investments in the productive capacity of people are accomplished mainly through activities such as education and training. Education and training programs are generally considered to be investments in human capital and available evidence suggest that they increase the earnings of participants. Some have suggested that social service, health, and nutritional assistance programs also represent investments in human capital. However, the effects on economic performance are even more difficult to establish for such programs and they are primarily justified by their social goals.

Research and development investment creates knowledge that can lead to new products or more efficient production processes. It is difficult to measure the economic returns from these activities, but there is some support that spending in this area has a positive effect on economic growth.

TRENDS IN FEDERAL INVESTMENT SPENDING

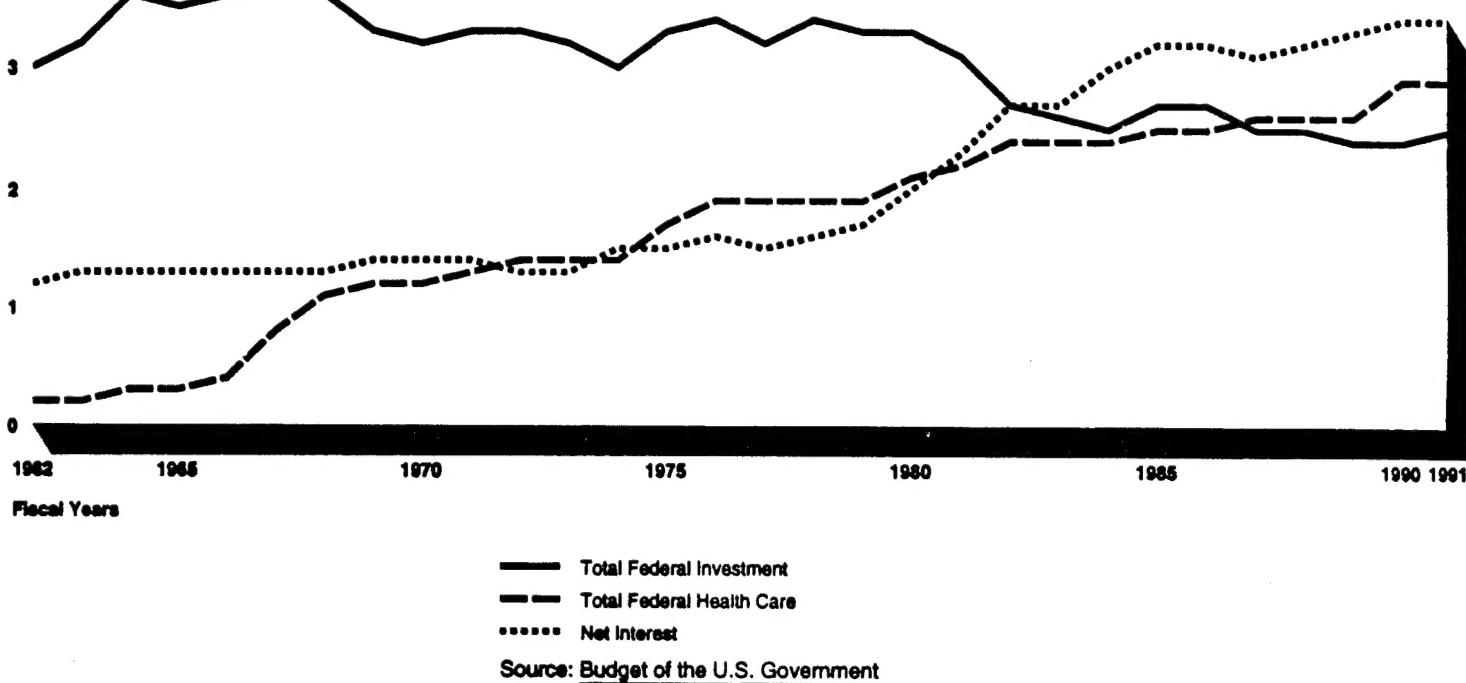
Currently, there is no analytic basis for determining the optimum level of federal investment nor the ideal mix among physical

capital, human capital, and research and development. However, a recent slowdown in spending for these purposes has prompted concerns.

The graph in Figure 1 shows that total federal outlays for investment programs declined as a share of GNP between 1980 and 1984 and have remained relatively stable at the lower level since then.

Figure 1: Federal Investment, Health and Net Interest Outlays (1962-1991)

4 Percent of GNP

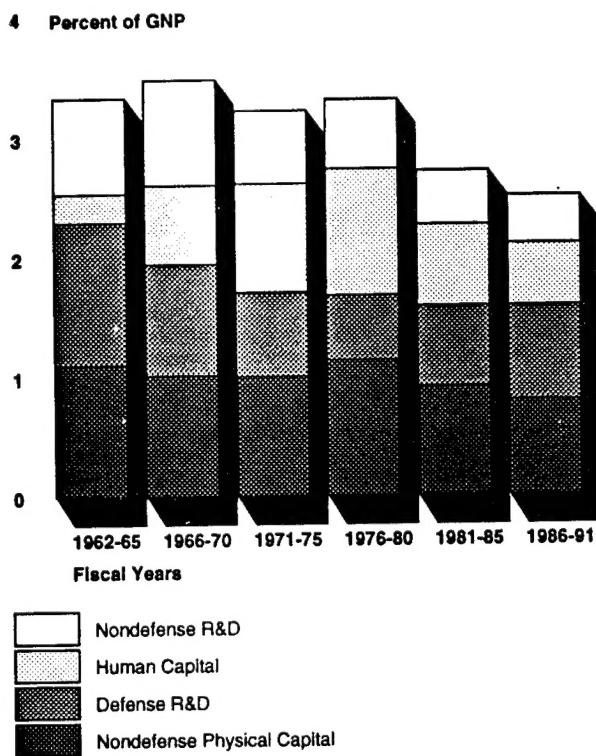


In comparison, federal spending for health care and net interest, which were historically much smaller than investment spending, have both exceeded investment spending since 1987. These trends reflect the growing share of the budget consumed by mandatory programs and

the consequent decline of the discretionary portion of the budget financing investment programs. Since 1962, mandatory outlays have grown from 29.9 percent of the budget in 1962 to 62.3 percent in 1992, while discretionary spending has fallen from 70.1 percent to 37.7 percent in the same period.

The composition of investment spending has changed over the years as well. As percentages of GNP, its components--defense research and development, human capital, nondefense research and development, and nondefense physical capital--have shifted since 1962, as shown in Figure 2.

**Figure 2: Federal Investment Outlays
(1962-1991)**



Source: Budget of the U.S. Government

Defense research and development contracted through the 1960s and 1970s and, despite growth in the 1980s, remains substantially below the level of the early 1960s. Human capital investment expanded dramatically in the 1960s and contracted in the 1980s. Nondefense research and development declined throughout the period and now represents only about half the share of GNP that it represented in the early 1960s. Nondefense physical capital investment has been more stable, but has experienced a modest decline from the 1960's.

BUDGET LACKS INVESTMENT ORIENTATION

These trends represent the accumulated result of thousands of individual budgetary decisions at the program level, but there is no reason to believe they comprise an explicit strategy for government investment. Simply put, the federal budget is not currently structured to facilitate broader decisions on overall investment strategy or priorities. Rather, all expenditures are treated the same regardless of their long-term investment character and future benefits generated for the economy as a whole.

Although federal programs vary considerably in their short-term and long-term effects on the nation's economy, the present budget structure does not encourage decisionmakers to take these differences into account in allocating resources among programs. Further, it is difficult to determine at the aggregate level if a proposed budget is more or less investment-oriented than the past

or competing alternatives. While a supplemental display is provided in the budget document listing programs and associated spending considered to have investment character, this information is assembled after the fact rather than being used as a basis for decisions in the executive branch or the Congress.

We have previously proposed a revised budget structure that would distinguish between capital and operating expenses. We have been working over the past several years to further specify and modify the restructured budget proposal. For example, the structure has since evolved to show operating and capital investment in terms of general, trust, and enterprise funds. This approach retained the unified budget totals to ensure a continued focus on the government's total financial operations, which is essential for assessing overall fiscal policy.

We are continuing to refine our proposed restructured budget presentation to better focus budget decisions. Departing from past conceptions of capital budgets, we are now considering a new investment category for the budget that would include some traditional physical capital and infrastructure programs as well as certain human capital and research and development programs not previously defined as capital in nature, whose goals are principally defined by their impacts on longer term economic growth. However, unlike previous definitions of capital budgets,

the investment category would in all likelihood exclude federally-owned capital programs whose principal purpose is to acquire assets for use in federal agency missions, such as government office buildings or weapons systems, except when the mission is investment in nature.

We are also exploring ways of incorporating tax expenditures in a more comprehensive budget framework to allow decisionmakers to consider all relevant federal resource commitments and subsidies. Tax expenditures are a major tool used by the federal government to influence economic activity and, in some areas, may have a far more profound effect on private economic choices than direct federal spending programs do. Despite their significance, the budget process currently provides only limited opportunities to focus on tradeoffs between related tax and spending programs in such areas as job creation and economic development.

Creating an investment oriented budget within the overall unified budget would provide a framework for developing, displaying, and analyzing the information needed for policymakers to consider investment effects of budget decisions. It would also create a vehicle that could be used to structure the process of making decisions about the allocation of resources.

Ultimately, transforming the federal budget into a future oriented and investment conscious vehicle will have to go beyond the provision of new information and budget displays. Specifically, the budget totals for investment need to become one of the central issues in making budgetary decisions. One way to do this would be for the Congress to explicitly decide the aggregate funding desired for investment programs in each year's budget. This overall level could be incorporated as a spending target to guide budget decisions, much as current targets for domestic, defense and international programs do for the discretionary portion of the budget.

IMPROVE SELECTION AND DESIGN OF INVESTMENT PROGRAMS

Increased visibility for investment programs in the budget is a first step in realizing a larger objective - assuring that scarce federal investment resources are provided for those programs and projects with the highest rates of return. This means making choices among competing investment strategies and programs so that limited federal resources can be used in ways that will have the greatest favorable effect on long-term growth. Ultimately, federal investment will increase net long-term wealth only if the benefits are greater than those that could be obtained from other uses of the funds.

Ideally, policymakers would have access to measures of the relative rates of return from federal investment programs as a basis for making resource allocation decisions among competing programs.

Let me say, however, that we are still a long way from developing the needed measures of program benefits to permit us to make these analytic judgements with any confidence. Reliable data of this sort are notable primarily for their absence.

Some of the research to date illustrates the potential impacts of investment programs, but additional research is clearly needed to provide more definitive information across the range of programs. In a recent report, the Congressional Budget Office (CBO) estimates a 30 to 40 percent expected real rate of return on investment to maintain current highway conditions, although the return range may underestimate costs in urban areas and benefits overall.¹ The economic effects of federal human capital investments are more difficult to measure, and the measurement problem is compounded because most human capital programs pursue social as well as economic goals. In the area of research, there is evidence of economic returns over the long-term for basic research and for academic research in science and engineering. However, federally funded research and development is usually evaluated on its

¹ How Federal Spending for Infrastructure and Other Public Investments Affects the Economy, Congressional Budget Office, July 1991.

contribution to agency missions, rather than in terms of its likely effect on the overall economy.

In addition to pointing to the most promising program areas for federal investment, research can also help define how to design these programs to maximize their impacts on productivity and growth. As with many federal programs, investment programs are in fact delivered through grants and other subsidies to various nonfederal entities, such as state and local governments and nonprofit organizations. The ultimate effects of these programs, then are critically dependent on the way these nonfederal entities respond. Some studies have shown that the delivery of federal aid for these purposes is conveyed through what economists would call "leaky buckets" and the funds do not in fact increase net investment spending. For example, a large portion of federal aid has been found to supplant state and local investment funds for such programs as highways and some tax expenditure programs such as the research and development tax credit subsidize activities that would have been undertaken in the absence of the subsidy.

CONCLUSIONS

Mr. Chairman, we share your concern about long-term economic growth and investment in the United States and about the role of budget decisions in affecting our long-term economic health. The most important contribution the federal government can make to a healthy

and growing U.S. economy and investment climate is to reduce the federal deficit. Therefore, bringing our fiscal house in order must be our first priority. In bringing down the deficit, it is important to recognize the unique contribution of investment programs to economic growth.

We believe that the investment implications of federal budget decisions need to be considered as those decisions are made. To do that, the choices presented by the budget need to be changed to more clearly reveal those implications. Better information on the costs and benefits of programs also needs to be available to decisionmakers. Both bills considered today - HR 4420 and HR 4558 - offer the possibility that these programs could be considered differently in budget deliberations. We hope that the introduction of these bills will help move the debate forward and look forward to working with the staff in refining these proposals.